COMMENT

A STRATEGIC ASSET THAT CAN WALK OUT THE DOOR

Energy & Utility Skills' Nick Ellins reflects on the rise of human capital as an investor concern.

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The labour market surrounding the UK's environmental utility businesses is sobering for infrastructure investors. Employment is at a record high, and unemployment at a record low, with salaries rising. But the Industrial Strategy and sponsoring department policies do not recognise utility workforces as ones to protect. Migration policy and sector reputational risks may impact the supply chain which ultimately delivers much of the utility business model. And regulatory price reviews historically hit the supply chain hard, often leading to the exit of large numbers of the direct workforce, along with their corporate memory and critical experience.

However, the focus of institutional investors is sharpening on human capital. Infrastructure investors tend to look to utilities such as water, gas, power and waste to energy for stable and predictable income streams. Their long-standing interest is based on confidence in successful companies and world class regulators.

But recently there has been disquiet in their relative haven. Political, regulatory, union and public scrutiny has increased greatly, and with this has come a heightened intolerance for companies who do not perform. Investors retain their belief in UK infrastructure sector success, but are increasingly vocal in stating their concerns.

Any essential service that delivers poor performance, receives ongoing regulatory fines or is unable to overcome negative perspectives from society, risks a descending spiral. That spiral diminishes reputation and trust, lowers outperformance, increases risk, brings resistance to bills and, if left unchecked, can lead to enough public mistrust and annoyance that future governments intervene, potentially even to change the core business model.

Investors are seeking evidence of sustainable approaches to avoid the spiral, along with assurance of a supportive policy and regulatory environment. One such evaluation method is environmental, social and governance (ESG). This is growing fast within investment houses, and includes the scrutiny of one of the highest contributors to company outperformance, reputation, resilience, the low carbon transition and societal delivery: human capital.

Analysts talk of the 'intangible abilities and skills of the workforce and the knowledge inherent within the organisation's structures, routines, systems and processes which contribute towards the knowledge capital of the organisation'. The value of the culturally diverse workforce on legitimacy and competitive advantage is also explicit.

As 2015 research by Coff and Raffie advised, the inherent problem with any business ignoring human capital is that, unlike the regulatory capital that the firm owns, it can simply walk out the door and never return.

Workforce Disclosure Initiative

One example of the rise in investor interest in human capital is the Workforce Disclosure Initiative (WDI). Created in response to institutional investors' concerns about a lack of meaningful data on company workforce management, 126 institutional investors with over £9 trillion of funds under management are acting as one. They seek robust evidence of the leaders and laggards in human equity management, wanting more than just finance, environment and corporate social responsibility impact statements. This includes the direct and indirect workforce.

The business rationale is simple. A skilled and motivated workforce, including the supply chain, is critical to delivering performance and outperformance. Poor workforce resilience often shows where other risks exist in the company and leadership.

Tired of hearing "our people are our greatest asset' but not seeing substance, investors want proof as to how companies nurture their whole operating workforce to secure future outperformance, innovation and future-proofing. Simply 'doing training' or keeping the status quo through 'learning and development' is not enough. More is sought to give confidence.

Investors want to see employers turn human capital into human equity as a strategic asset. Key questions include: does workforce planning and a strategy exist with robust numbers and statements? Do the direction of travel statements, trends, benchmarks, comparisons and accompanying evidence suggest the asset owner can access the right labour and know what it is trying to do through its people?

Workforce resilience analysis goes further that simply protecting shareholder returns. It indicates good governance and that consumers, employees and stakeholders can trust in the sustainable value of the business.

One adviser for Legal & General Investment Management commented of the WDI: "As a large and long-term investor, information on a company's culture and employee engagement is important to understand the sustainability of business practices and long-term prospects. The WDI provides this disclosure on a consistent and comparable basis and is therefore an extremely useful format for LGIM to integrate into its assessment of company performance."

Sustainable business

ESG is bringing a different mindset to asset ownership, focusing on long-term performance and value creation rather than shorter-term views on corporate ratios or immediate earnings. Human capital is inextricably tied to social capital. Investors want to see employers show how the way they do business now will adapt for the human capital and environmental challenges of the future.

My final words go to Aberdeen Standard Investments. It advises: "Our attention on human capital management and labour issues has significantly increased over the recent years. We consider these issues important, not just from an ESG investment perspective as a socially responsible investor, but also in respect of their link to sustainable business performance of companies, which ultimately will have an impact on shareholder value. This attention is only going to increase as more meaningful workforce data becomes available and more companies start to take human capital management seriously as a key driver of value creation." TWR